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FREE TRADE AT RISK?

AN HISTORICAL PERSPECTIVE

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ABSTRACT

The recent theoretical literature on strategic trade policy suggests that government intervention in international trade has the potential to be welfare-improving, thus bringing into question the traditional economic case for free trade. Economists in the nineteenth century also argued about whether theoretical justifications for tariffs compromised the case for free trade. This paper discusses two older debates somewhat related to the current focus on strategic industries and reciprocity, and concludes with an observation about how developments in economic theory affect economists' view of policy.

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An Historical Perspective

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Introduction

The recent theoretical literature on strategic trade policy suggests that government intervention in international trade has the potential to be welfare-improving (Brander, 1986; Krugman, 1987). Government promotion of exports from imperfectly competitive industries, for example, may enable domestic firms to capture economic rents from foreign firms, thereby increasing national welfare. In addition, active responses to foreign protection, by a policy of reciprocity, may be required to prevent a loss of domestic welfare. Although these findings may bring into question the traditional economic case for free trade, many economists doubt that these theories provide sound guidance for trade policy (Bhagwati, 1989; Corden, 1990; Grossman, 1986).

Economists in the nineteenth century also argued about whether theoretical justifications for tariffs compromised the case for free trade. This paper discusses two older debates somewhat related to the current focus on strategic industries and reciprocity, and concludes with

1. The author is a staff economist in the Division of International Finance. This paper represents the views of the author and should not be interpreted as reflecting the views of the Board of Governors of the Federal Reserve System or other members of its staff. This paper is forthcoming in the Journal of Economic Perspectives. I wish to thank Jagdish Bhagwati for many helpful discussions and the editors for their suggestions.

an observation about how developments in economic theory affect economists' view of policy.

The Infant Industry Debate

The current attention given to promoting key economic sectors is somewhat analogous to the earlier attention given to assisting infant industries. Adam Smith and many of the classical economists did not accept the infant industry argument for import protection as a legitimate exception to free trade. Smith (1976, I, pp. 463-65), for example, argued that protective tariffs were appropriate in only two instances: to encourage industries essential to national defense and to offset domestic taxation of import-competing goods. Early advocates of the infant industry doctrine, such as Alexander Hamilton, Friedrich List, and mercantilist writers, were usually dismissed as ill-informed, nationalist, or just crudely protectionist.

The doctrine gained formal acceptance into international trade theory in 1848 when John Stuart Mill published the first edition of his Principles of Political Economy. His original statement was as follows ([1848] 1909, p. 922):

> The only case in which, on mere principles of political economy, protecting duties can be defensible, is when they are imposed temporarily (especially in a young and rising nation) in hopes of naturalizing a foreign industry, in itself perfectly suitable to the circumstances of the country. The superiority of one country over another in a branch of production often arises only from having begun it sooner. There may be no inherent advantage on one part, or disadvantage on the other, but only a present superiority of acquired skill and experience. A country which has this skill and experience yet to acquire, may in other respects be better adapted to the production than those which were earlier in the field. . . . A protecting duty, continued for

> a reasonable time, will sometimes be the least inconvenient mode in which the nation can tax itself for the support of such an experiment. But the protection should be confined to cases in which there is good ground of assurance that the industry which it fosters will after a time be able to dispense with it; nor should the domestic producers ever be allowed to expect that it will be continued to them beyond the time necessary for a fair trial of what they are capable of accomplishing.

Mill's standing and reputation in economics gave intellectual credibility to the infant industry argument for the first time. Other economists and intellectuals, who viewed free trade as the best policy for all countries regardless of the circumstances, were dismayed by the respectability Mill lent to protection. The liberal reformer John Bright bitterly remarked that Mill's single paragraph on infant industries "would cause hereafter more injury to the world than all his writings would do good" (quoted in Carnegie, 1902, p. 313).

Complaints soon reached Mill about how his statement was being distorted by protectionists to justify high tariffs in the United States, Canada, and Australia. In his replies, Mill condemned any general policy of protection--"an organised system of pillage of the many by the few," he called it--but reiterated that, in principle, the infant industry claim to protection was valid (Elliot, 1910, II, p. 295). But the complaints persisted and by the 1860s Mill grew to question his own approval of the doctrine. To one correspondent Mill sighed (p. 117), "But I confess that I almost despair of this general understanding [of the limits of the infant industry case] being ever practically established. I find that in Australia, protection is not advocated in this form or for this purpose, but that the vulgarest and most exploded fallacies are revived in its support." Eventually, Mill recanted his view that import protection was an appropriate means of promoting infant industries (p. 155): "I am now much shaken in the opinion, which has so often been quoted for purposes which it did not warrant; and I am disposed to think that when it is advisable, as it may sometimes be, to subsidise a new industry in its commencement, this had better be done by a direct annual grant, which is far less likely to be continued after the conditions which alone justified it have ceased to exist." Curiously, Mill never incorporated these views in later editions of the Principles, although he did slightly qualify his approval of protection for infant industries.[2]

The controversy surrounding Mill's treatment of infant industries may have prompted two fledgling economists, Alfred Marshall and Frank Taussig, to undertake empirical investigations in the 1870s into the economic effects of infant industry policies in the United States. Unlike most earlier economists, Marshall and Taussig accepted the infant industry case for tariff protection and believed that it did indeed compromise the universal nature of the case for free trade. Marshall was particularly insistent that, although free trade was clearly in Britain's best interests, it was not necessarily best for other

2. The only textual changes Mill made to the Principles, from the 7th edition in 1871, was to replace "a protecting duty. . .will sometimes be" with "might sometimes be" and to add "it is essential that the protection should be confined. . ."

countries in a different stage of development.[3] Taussig (1905, p. 47) believed that the infant industry argument harmed the case for free trade because it required the economist to be agnostic, for "whether protection to young industries will or will not have good effects is simply a question of probability for the given case."

Yet from their examination of the U.S. experience with infant industry protection, Marshall and Taussig came to appreciate the difficulties associated with such protection in practice. Although he visited the United States in 1875 with an open mind, Marshall ([1903] 1926, pp. 393-94) "came back convinced that a protective policy, in fact, was a very different thing from a protective policy as painted by sanguine economists . . . [H]owever simple the plan on which a protective policy started, it was drawn on irresistably to become intricate, and to lend its chief aid to those industries which were already strong enough to do without it." And "notwithstanding the presence of these conditions" favorable to infant industry protection in early 19th century America, Taussig (1883, p. 28) concluded in his doctoral dissertation that "little, if anything, was gained by" protection. Although he cautioned that the "intrinsic soundness of the argument for protection to young industries . . . may not be touched by the conclusions drawn from the history of its trial in the United States," Taussig was aware that protection, by diminishing competition, was always in danger of

3. Marshall ([1903] 1926, p. 388) criticized the dogmatism of the early English free traders who refused to admit any case for protection. This had the unfortunate effect of putting "many of the most far-seeing and public-spirited statesmen and economists in other countries into an attitude of hostility to their position as a whole," thereby causing "able men to deny. . . economic truths as certain as those of geometry."

encouraging "the retention of antiquated and inefficient methods of production" instead of promoting the adoption of innovations and improvements to production.

These generally unenthusiastic studies were supplemented by theoretical work which provided additional reasons for being skeptical of infant industry protection. Charles Bastable (1887), for example, pointed out that for the infant industry policy to have an economic basis, the future benefits from the industry must exceed the current costs of protection. Other economists raised the problems of identifying infant industries and of avoiding the capture of protection by economic interest groups.

Thus, despite the <u>angst</u> initially created in the profession, the infant industry doctrine did not ultimately pose a serious detriment to advocates of free trade because the limits of the case became better understood with time. While accepting the infant industry argument for protection in principle, many economists by the turn of the century doubted its practical importance.

The Reciprocity and Tariffs Debate

In advocating free trade, Adam Smith and the classical economists focused almost exclusively on the protectionist policies of their own country, Britain, to the relative neglect of foreign protectionism. Although they willingly admitted that foreign tariffs were harmful in limiting the international division of labor, a reduction in Britain's tariff was held to improve economic welfare at home regardless of foreign trade barriers. Adam Smith (1976, I, p. 468) did concede that retaliatory tariffs might prove useful "when they will procure the repeal of the high duties or prohibitions complained of." But "when there is no probability that any such repeal can be procured," he added, "it seems a bad method of compensating the injury done to certain classes of our people, to do another injury ourselves." Furthermore, the almost certain prospect of counter-retaliation allowed Smith and others to rest assured that such a policy would be unwise.

As prospects for tariff reform in Britain improved, economists took a closer look at the economic effects of free trade. Robert Torrens earned his free trade credentials by independently discovering the theory of comparative advantage with David Ricardo, but later strongly opposed a unilateral tariff reduction in the face of foreign protectionism. Torrens (1844, p. 50) maintained that "the sound principle of commercial policy is to oppose foreign tariffs by retaliatory duties and to lower our import duties in favour of those countries which may consent to trade with us on terms of reciprocity." His analysis suggested that while bilateral tariff reductions would be mutually beneficial, a unilateral tariff reduction would result in an economic loss through a deterioration in the terms of trade: lower tariffs would increase import demand and hence import prices (net of tariff), while the additional exports required to pay for the imports would depress export prices. Contrary to Adam Smith, therefore, Torrens asserted that a country could gain by keeping its retaliatory tariff in place even if the foreign country did not change its tariff.

Torrens also believed that Britain had sufficient leverage to induce other countries to agree to tariff reductions. As he (1844, p. 354) put it, "by the maintenance of retaliatory duties against countries refusing to receive British goods on terms of reciprocity . . . we shall render it the palpable and unmistakable interest of foreign states to act upon the true principles of free trade."

Other free traders were sharply critical of Torrens.[4] Most economists rejected his theoretical contention and continued to believe that domestic tariff reforms would be advantageous despite the presence of foreign trade barriers. They also denied his policy prescription by viewing foreign tariffs as immutable and retaliatory tariffs as certain to provoke counter-retaliation. But when John Stuart Mill generally supported Torrens's claims in developing the theory of reciprocal demand, in which supply and demand were used to determine the equilibrium terms of trade, economists became convinced that Torrens had established a valid theoretical point regarding tariffs and the terms of trade, even if his policy guidelines were disputable. Mill, however, sought to limit the applicability of Torrens's analysis by making a distinction between protecting duties, which always entailed a loss by distorting domestic production, and revenue duties, levied on imported goods not produced at home. As Mill (1844, p. 29) explained, "considerations of reciprocity, which are quite unessential when the matter in debate is a protecting duty, are of material importance when the repeal of [revenue] duties. . . is discussed. The only mode in which a country can save itself from

4. For a review of the debate, see Irwin (1988). J. L. Mallet's diary entry gives an indication of the suspicion and hostility with which Torrens's views were received at a Political Economy Club meeting in 1835: "The first question discussed was a question of Torrens, which was unanimously voted to turn upon an impossible case. He claimed the right to discuss any abstract proposition with a view to the establishing of principle, but it was over-ruled in the present case which did not go to establish but to disturb a principle, that of free trade." Political Economy Club (1921), p. 270.

being a loser by the duties imposed by other countries on its commodities is to impose corresponding duties on theirs."

Around the turn of the century, economists further expanded the economic case for tariffs using Marshallian supply and demand analysis. Charles Bickerdike (1906) formalized Torrens's terms-of-trade argument for tariffs using offer curves. Going beyond Mill, Bickerdike demonstrated that small or "incipient" tariffs--even if protective--could redound to the benefit of the country imposing such taxes. Yet despite the outpouring of theoretical work on tariffs using the analytical tools he had developed, Marshall ([1890] 1925, p. 263) was convinced that the reintroduction of tariffs in England would "be an unmixed and grievous evil." This sentiment was shared by other theoretical economists at the time.[5] Although F. Y. Edgeworth (1894) had tried to show the existence in theory of a variety of circumstances in which tariffs would be paid by foreigners, he doubted whether governments could adequately discriminate between the various cases. And although Edgeworth respected Bickerdike's ingenuity as a theorist, he (1908, pp. 555-56) cautioned: "the direct use of the theory is likely to be small. But it is to be feared that its abuse will be considerable. . . Let us admire the skill of the analyst, but label the subject of his investigation POISON."

Marshall ([1903] 1926, p. 408) conceded that rejection of reciprocity in favor free trade with all countries "has not the strength of scientific demonstration." But he maintained that "England is not in

5. In his detailed survey of economic thought in this period, Jha (1963, p. 200) concluded that "theoretical developments did not in any way weaken the faith of the majority of British economists in the policy of free trade as the best one for England and other industrially advanced countries."

a strong position for reprisals against hostile tariffs, because there are no important exports of hers, which other countries need so urgently as to be willing to take from her at considerably increased costs; and because none of her rivals would permanently suffer serious injury through the partial exclusion of any products of theirs with which England can afford to dispense." He concluded (p. 401) that it was "contrary to England's interests to levy import duties with the object of giving English diplomatists something to bargain with when discussing foreign tariffs" because reopening the tariff question in any form would only spark lobbying for tariffs and lead to corrupt politics.[6]

Even in the United States, where the intellectual climate was favorable to activist trade policies designed to ensure fair treatment for U.S. exports, economists grew to become suspicious of reciprocity in practice. Frank Taussig, then chairman of the U.S. Tariff Commission and assisted by Jacob Viner and others, issued an influential study in 1919 that rejected reciprocity in terms of bilateral bargaining under a conditional most-favored-nation (MFN) tariff policy. Such a policy, they concluded, led to potential losses from trade diversion (imports from high cost countries) and increased the chances of foreign discrimination against U.S. exports. "A great gain would be secured," Taussig and the others argued (U.S. Tariff Commission 1919, p. 10), if the United States were to adopt a simple unconditional MFN policy and treat imports from all countries alike.

6. See Bhagwati and Irwin (1987) for details on the reciprocity debate.

Conclusion

In his presidential address before the American Economic Association, Taussig (1905, pp. 30-1) spoke of how the economist's confidence in free trade had been eroded because "the whole structure of economic theory is undergoing revision." "So far as the doctrine of free trade is concerned," he continued, "enthusiasm has been supplanted by cautious weighing or open doubt. . . Free trade would seem to be the waning doctrine." Yet Taussig concluded (p. 63) that "the fundamental principle of free trade has been little shaken by all the discussion and all the untoward events of the past half-century. But its application is not so easy and simple as was thought by the economists of a century ago." To Taussig, the reason for the resilience of free trade was clear (p. 65): "The essence of the doctrine of free trade is that *prima facie* international trade brings a gain and that restrictions on it presumably bring a loss. Departures from this principle, though by no means impossible of justification, need to prove their case."

I suspect that Taussig's words remain relevant today. Theories emerge periodically suggesting how tariffs can, under certain and particular circumstances, be beneficial, and these theories struggle to gain acceptance into the main body of economic theory. When legitimate exceptions to free trade are accepted into economic theory, there may come a period of diminished confidence among economists in free trade as a policy. Yet repetition of this pattern over the decades has not ultimately led to uneasiness among economists in their belief that the gains from international trade are substantial and that a free trade policy is difficult to improve upon. Identification of possible exceptions to free trade by economic theorists means neither that such circumstances can be isolated and identified in practice nor that such exceptions would constitute sound economic policy. If the past is any guide, new theories related to strategic trade policy will indeed provide important economic insights, but will not fundamentally challenge the belief of economists in free trade.

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